

**WRITTEN STATEMENT OF
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DIVISION
INTERNAL REVENUE SERVICE
BEFORE THE
HOUSE COMMITTEE ON SMALL BUSINESS
SUBCOMMITTEE ON REGULATIONS, HEALTHCARE AND
TRADE**

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Good morning, Chairman Gonzalez, Ranking Member Westmoreland, and distinguished members of the Subcommittee. My name is Chris Wagner and I am the Deputy Commissioner of the Internal Revenue Service' Small Business/Self-Employed Division (SB/SE).

The SB/SE organization is made up of 26,000 employees who serve about 57 million taxpayers – roughly one third of the taxpaying population. Our taxpayer base consists of nine million small businesses, including corporations and partnerships with assets of \$10 million or less; 41 million self-employed and supplemental income earners; and seven million other taxpayers who file employment, excise, estate, gift, fiduciary and international tax returns.

Small business men and women play a critical role in our nation's economy. Small businesses represent more than 99 percent of all employers and employ half of all private-sector workers. My division at the IRS is focused on serving the small business and self-employed taxpayer community by helping them comply with their tax obligations. Much of this mission is accomplished through education and outreach efforts.

Today, I will discuss some of those efforts, including those related to the home office deduction. But first I will address our compliance with the Regulatory Flexibility Act and the opportunities we provide small businesses and the groups that represent them to influence proposed regulations and to modify regulations after they have been issued.

IRS Compliance with the Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) is a critical tool which requires Federal agencies to complete and publish a regulatory flexibility analysis when a proposed regulation will have a significant economic impact on a substantial number of small entities. The IRS takes its responsibilities under the RFA very seriously and within the IRS, compliance with the RFA is carried out primarily by

the Office of Chief Counsel, working with the Treasury Department's Office of Tax Policy and Office of General Counsel.

However, for a number of reasons, not the least of which is the nature of the tax laws enacted by Congress, the impact of the RFA on the IRS is not as great as it is on other Federal agencies. Many of the tax laws enacted by Congress are very specific and as such the regulations issued by the IRS to implement those laws tend to be interpretive. In addition, when considering the impact of a tax regulation on small business, we are allowed to consider only the administrative impact of compliance not the burden the tax itself may have on a small entity. As such, most of the regulations issued by the IRS are not subject to review under the RFA.

I should stress that even though specific regulations may not be subject to RFA, small businesses still have the opportunity to review, comment, and influence the outcome of an IRS regulation prior to adoption. In addition to our internal review of the regulations to determine compliance with the RFA, section 7805 of the Internal Revenue Code requires the IRS to send every published Notice of Proposed Rule Making to the Chief Counsel for Advocacy of the Small Business Administration for comment. The IRS considers and responds to all comments made by the Office of Advocacy in the final regulations.

The RFA also requires agencies to review certain regulations after publication. However, again, because of the interpretative nature of most IRS regulations, there are only a very small number of tax regulations that are subject to retrospective review as required by RFA.

However, each year the Treasury Department and the IRS solicit input from the public, including small entities, concerning subjects on which the public would like to see published guidance. Public submissions often include recommendations to revise existing regulations. The cost or difficulty in complying with existing regulations, or a complaint that regulations adversely affect small entities, are potential grounds to amend the regulations.

Those comments and submissions are carefully considered by Treasury Department and the IRS in compiling the annual Guidance Priority Plan, as well as in drafting the text of the regulations themselves.

Efforts to Help Small Businesses and the Self-Employed

The Small Business/Self Employed division of the IRS does not exist just to enforce the law against small business. We have an obligation – in fact a core value – to also assist small businesses understand and comply with the tax law through a series of taxpayer service programs. This taxpayer service aspect of what we do is critical because we know that some noncompliance reflects a lack of understanding by the small business of their true tax obligation.

For example, one of the issues that I know this Subcommittee is very interested in is the home office deduction. I discuss this issue in greater detail later in my statement. However, below are a few of the ways we work with the public and third party stakeholders to help small businesses comply with the home office deduction provisions:

- We have posted information on IRS.gov, such as Tax Topic 509, which provides basic guidelines and links to other resources, including Publication 587, Business Use of Your Home, and Form 8829, Expenses for Business Use of Your Home.
- We work with partners, such as the Small Business Administration, state and local government agencies and community organizations to provide Small Business Tax Workshops and other educational seminars to current and prospective business people throughout the United States. Home office issues are discussed in many of these events by qualified instructors, such as IRS technicians and tax professionals.
- We have produced educational materials to supplement forms and publications, such as the Virtual Small Business Tax Workshop, which can be viewed online at IRS.gov or ordered as a DVD – up to five copies may be ordered for free. An entire chapter of the workshop is devoted to home office expenses.
- We issued Fact Sheet FS-2006-25, Home Office Deduction Reminders, in September 2006. The fact sheet is still used in outreach and is available on IRS.gov in English and Spanish. We are currently working to update the material and expect to reissue the fact sheet this fall.

Burden Reduction

In addition to reaching out and trying to assist small businesses comply with the law, the IRS also has an Office of Taxpayer Burden Reduction (OTBR) which exists, at least in part, to reduce the burden on small entities. Some of the steps take by OTBR to reduce the burden on small business include:

- Form 13285A, Reducing Taxpayer Burden on America's Taxpayers, was created so the public could participate in identifying taxpayer burden reduction. This form provides taxpayers with a process for submitting ideas for consideration directly to the Office of Taxpayer Burden Reduction. The form is available on IRS.gov.
- The Industry Issue Resolution (IIR) program was created to give taxpayers, industry associations, and other interested parties a vehicle for submitting burdensome business tax issues for possible resolution through published or administrative guidance. The goal is to resolve quickly tax issues that are common to a significant number of business

taxpayers by providing targeted guidance on specific tax issues. Under the program, the IRS has issued guidance that has reduced costs, burden, and uncertainty for taxpayers.

- Practitioner and Small Business Forums with national and local level tax professionals and small business associations provide an opportunity for taxpayers to share feedback on burden reduction initiatives before they are implemented. These forums also provide a means for identifying and resolving burden issues and communicating initiatives as they become available.

Completed Projects

Recently we have completed a number of projects that should be of benefit to small businesses:

- **Increased the Business Expense Threshold to \$5,000 from \$2,500 on Form 1040, Schedule C-EZ** – The threshold for small business taxpayers who file Schedules C or C-EZ for reporting business expenses was raised from \$2,500 to \$5,000. This enabled approximately 500,000 eligible taxpayers to file a Schedule C-EZ instead of the regular Schedule C.
- **S Corporation Elections** – Implemented Revenue Procedure 2007-62 which provides a simplified method for taxpayers to request relief for a late S corporation election. This now permits taxpayers to file Form 1120S, U.S. Income Tax Return for an S Corporation, and Form 2553, S Corporation Election, simultaneously. The change was effective for taxable years ending on or after Dec. 31, 2007.
- **Extensions to File** – Individuals, including Form 1040 Schedule C filers, are now able to use a redesigned IRS Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, to get an automatic six-month extension of time to file. This replaces the prior two-step process.
- **Form 940 (Employer's Annual Federal Unemployment Tax Return) Redesign** – The Form 940 and Form 940EZ have been combined into one simplified plain language form and have been designed for scanning.
- **Increase the FUTA Minimum Deposit Threshold** – Effective 2005, we increased the threshold for FUTA deposits \$100 to \$500. The reduced burden for 2.6 million taxpayers per year and eliminated the requirement for taxpayers with eight or less employees from having to make three tax deposits a year. This saved taxpayers who fall under the new threshold from having to make 7.8 million deposits a year.
- **Redesigned Form 941** – Revised in 2005, the new version features and improved layout and employs "plain language" instructions.

- **Form 944** - Beginning in 2006, small business taxpayers can file their Employment Taxes once a year using Form 944, instead of four quarterly Form 941 returns. Currently about 500,000 taxpayers benefit from this program.
- **Outreach** – We launched a campaign in April to help educate new small business owners. The effort will provide first-time Schedule C (Profit or Loss from Business) filers with improved and updated educational materials on a variety of issues including home office deductions.

The Home Office Deduction

One of the issues of interest to this Subcommittee and on which we attempted to relieve the burden on small businesses is the home office deduction. We have received extensive comments on the need to simplify the deduction and we have looked at ways to simplify the deduction so that everyone who is eligible can claim it.

In 1976, Congress passed legislation limiting tax deductions for offices in the home. Internal Revenue Code (IRC) section 280A, enacted in 1976 and revised in 1997, provides the limited circumstances in which an individual or an S corporation taxpayer may take a deduction for an office in the home.

The deductions for home office expenses are generally limited to parts of a home that are exclusively used on a regular basis:

- As a principal place of business for any of trade or business,
- As a place of business used by patients, clients, or customers to meet in the normal course of trade or business, or
- In connection with a trade or business if in a separate structure that is not attached to the home.

Exceptions to these rules apply to space used on a regular basis for storage of inventory or product samples and used for certain daycare facilities.

Changes made by the Tax Relief Act of 1997 expanded the definition of a taxpayer's "principal place of business" to allow more taxpayers to deduct home office expenses. This was a legislative override of a Supreme Court case (Commissioner v. Soliman, 506 U.S. 168 (1993)) that denied a home office deduction to an anesthesiologist who had no place but his home office to perform the administrative duties of his medical practice. Under the change, a taxpayer such as an anesthesiologist, an independent plumber, or a health care worker, whose business is mainly conducted and revenue generated outside the home office, may nonetheless claim the home office deduction if he or she has no other

location in which to conduct the management and administrative duties of the business. This change increased the number of taxpayers eligible for the deduction without affecting the intended unambiguous relationship to business activity.

Due to technological advancements and other significant changes to the business environment since 1976, many more small businesses are now able to operate effectively out of the home. In fact, according to the Small Business Administration, home-based businesses represent over 50 percent of small businesses. This evolution makes the benefit of claiming a business deduction for an office in the home ever more valuable to small business taxpayers.

We have also seen a growth in the use of the office in the home deduction on tax returns with the self-employed business schedule attached from 2.6 million in Tax Year (TY) 2002 to 3.3 million in TY 2006. Even with this increase, there are some indications from Census surveys that a substantial number of taxpayers with home office expenses are not claiming them on tax returns.

One of the reasons that the home office deduction might be underutilized might be that understanding and complying with the rules for deducting home office expenses can be difficult for small business and self-employed taxpayers. The clear intent of the law was to limit deductions of business use of the home to those expenses that have an unambiguous relationship to the business activity as opposed to personal use.

Taxpayers claiming deductions for home office expenses must not only understand the rules for when a business deduction is permitted, but they also must make appropriate computations and keep records to substantiate those deductions. As part of the record keeping, taxpayers must ensure that they do not double deduct expenses related to the home that are already permitted as an itemized deduction on their return, and they must ensure they take appropriate recognition steps if they sell their home.

However, from data collected by the IRS it is clear that many taxpayers do not understand this process.

In August 2007, the IRS conducted an analysis of the National Research Program (NRP) study of Tax Year 2001 individual returns and found that a significant number of taxpayers made errors when claiming home office deductions.

Using the NRP data, we estimate that almost 2.3 million – 1.8 percent – of the timely-filed tax returns for 2001 deducted home office expenses on Schedule C, for a total deduction amount of around \$5.8 billion. We further estimate that 33.7 percent of those taxpayers overstated their deduction, 12.8 percent understated their deduction, and only 53.6 percent reported the correct amount.

In other words, almost half the taxpayers claiming a home office deduction made errors. The data does not show whether these errors were unintentional and simply a result of the complexity of the regulations or whether they represented deliberately misreported amounts.

The IRS' Office of Taxpayer Burden Reduction has taken a close look at the home office deduction to determine what options are available to make claiming the deduction easier. The Office explored a number of possible ways to simplify the computations required to claim the business deduction and concluded that reducing burden on business taxpayers with home office expenses may be best accomplished through a legislative change.

One of the problems we identified was the statutory requirement to recapture depreciation. Homeowners claiming deductions for an office in their personal residence are required to recapture depreciation "allowed or allowable" when selling their home – in other words, whether a depreciation deduction is claimed or not. That means additional computations and a possible tax liability when the home is sold, even if they had not included a depreciation deduction on their tax returns.

The IRS will continue to look at this issue, including exploring opportunities to simplify the rules and make Form 8829 easier to use.

It is our aim to find ways to ensure those who work out of their homes and are entitled to take the deduction can do so as accurately and with as little burden as possible.

Thank you, Mr. Chairman. I will be happy to answer any questions you and the other Members of the Subcommittee may have.